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No. 08-164

IN THE
Supreme Court of the United States

VISION SERVICE PLAN,
Petitioner,

v.

UNITED STATES,
Respondent.

On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the Ninth Circuit

REPLY BRIEF FOR PETITIONER

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, petitioner states that it has no parent companies and no publicly owned company owning 10% or more of its stock.

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Christopher M. Jedrey & Charles R. Buck,
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REPLY BRIEF FOR PETITIONER

In its Brief in Opposition, the Government silently — but directly — aims a dagger at the heart of the healthcare industry's critical non-profit sector. The IRS's approach profoundly threatens other tax-exempt organizations as well. *E.g.*, Prevent Blindness *Amicus* Br. 8-10. With its "business as usual" tone, the Government seeks to elide the pivotal fact that VSP has done nothing to change its business model since its federal tax exemption was first recognized — and thereafter honored — over 40 years ago.

With no supervening law (or even modified regulations), the IRS has done a behind-closed-doors about-face. The revenue-gathering bureau now disdains non-profit HMOs because, in the IRS's exercise of unfettered enforcement discretion, non-profit HMOs somehow look like for-profit HMOs. Indeed, in defending the Ninth Circuit's death-knell-to-non-profit-HMOs approach, the Government defends the decision below almost entirely on the basis of two premises: (1) that Vision Service Plan's operations "are primarily oriented toward its private subscribers," BIO 10, and (2) that it engages in "ordinary commercial activity" in competition with for-profit enterprises. BIO 12. But the fundamental reality is this: Both these facts are essential characteristics of health maintenance organizations generally; they are "absolutely necessary to the existence of nonprofit HMOs." Jones *Amicus* Br. 9; *see* Prevent Blindness *Amicus* Br. 6, 9-10.

Tellingly, the Government does not respond persuasively to our showing that the IRS's newly-minted position departs from long-established law.

Pet. 11-15. *See also* Prevent Blindness *Amicus* Br. 16-17; National Taxpayers Union *Amicus* Br. 3-9. Indeed, this destabilizing departure from long-understood principles — upon which numerous non-profit organizations have relied for decades in fashioning their organizational structure — finds no warrant in Congressional intent, which is demonstrably to the contrary. *See* Pet. 15-18; Jones *Amicus* Br. 6-8; Prevent Blindness *Amicus* Br. 17-21. The matter is one of substantial national importance, both practically and jurisprudentially. It urgently calls for this Court's attention.

I. VSP Is "Primarily Engaged in Promoting the Common Good," Through Promotion of Health Care for a Substantial Segment of the Community.

The Government acknowledges that VSP's "primary activity is to arrange vision-care services by connecting its paying subscribers and their enrollees to petitioner's participating providers." BIO 12. However, the Government maintains that this fact does not make VSP a "social welfare organization" under § 501(c)(4), arguing that its operations are "primarily oriented towards its private subscribers rather than toward the general public." BIO 10. The Government also asserts that "petitioner is wrong in contending (Pet. 11) that the promotion of health, standing alone, is an exempt purpose." BIO 13. For multiple reasons, the Government is wrong.

1. The Government's new position directly conflicts with Revenue Ruling 69-545, 1969-2 C.B. 117, which recognizes that promotion of health "is deemed beneficial to the community as a whole, *even though the class of beneficiaries eligible to receive a*

direct benefit from its activities does not include all members of the community, . . . provided that the class is not so small that its relief is not of benefit to the community." (Emphasis added). When the IRS later sought to back away from this position, the Tax Court firmly slapped it down, pointing out that "no charity has ever succeeded in benefiting every member of the community." *Sound Health Ass'n v. Comm'r*, 71 T.C. 158, 185 (1978). The Service acquiesced in that decision. 1981-2 C.B. 1. It now seeks to turn a blind eye on its acquiescence. The Ninth Circuit wrongly permitted it to do so.[1]

2. The Government relies on several cases for the proposition that "[a]n organization that operates primarily for the benefit of its members, rather than for the benefit of the community as a whole, is not exempt." BIO 8-10. None of these cases involved organizations promoting health care or serving another manifestly charitable purpose, such as education or religion. Nor did these cases present situations where the membership form of organization is absolutely essential to the accomplishment of the charitable purpose, *see* Jones

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[1] Revenue Ruling 69-545 correctly relied on and followed the common law of charitable trusts. The Government does not deny this, but asserts that the issue whether VSP "is a charitable organization under the common law of charitable trusts" was not raised below, and that this Court should not consider it. BIO 13. Not true.

VSP consistently argued that it qualified as "charitable" under the common law and within the meaning of § 501(c)(3), and *a fortiori* that it qualified as a "social welfare organization" under § 501(c)(4); it consistently relied on Rev. Rul. 69-545. *E.g.*, Brief on Appeal at 12-17, 24-25, 40; Reply Brief at 11-12.

Amicus Br. 3-4, 9, and in fact is required by federal law. *See* Prevent Blindness *Amicus* Br. 9-10.

In the cases cited, the taxpayers were organizations formed primarily for the private benefit of the founding members. They sought tax exemption on the basis of incidental benefits to the public at large.[2] The isolated excerpts quoted from these cases must be read in light of the facts to which they related and the issues before those courts. Read

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[2] In *Better Business Bureau, Inc. v. United States,* 326 U.S. 279 (1945), the taxpayer was a business league, primarily concerned with the profitability of its members, but performing an incidental educational function. In *Contracting Plumbers Coop. Restoration Corp. v. United States,* 488 F.2d 684 (2d Cir. 1973), the taxpayer was a plumbers' cooperative that made arrangements for street repairs for which its members were severally liable, billing the responsible member for the services. In *American Women Buyers Club v. United States,* 338 F.2d 526 (2d Cir. 1964), the taxpayer was a "tight little trade association" that primarily engaged in social activities and professional development for its members – concededly not "social welfare" functions – but incidentally provided them with health insurance. *Id.* at 428. In *Commissioner v. Lake Forest, Inc.*, 305 F.2d 814 (4th Cir. 1962), the taxpayer was a "private economic enterprise," a housing cooperative formed to acquire and maintain the housing in which its members lived; membership in the organization was limited to such residents. *Id.* at 816-817. These organizations are not remotely comparable to VSP in their mission or in their activities. *See* Pet. 6-8; BIO 4, 6 (admitting that over 40% of VSP's enrollees are beneficiaries of Government programs such as Medicaid; VSP spends 24% of its net income on charitable activities).

The Government's description of these cases is misleadingly incomplete. In particular, *Lake Forest* was not an organization for relief of veterans generally, as the Government implies. BIO 9. The nature of the enterprise was primarily private and economic, not social welfare or veterans' relief. 305 F.2d at 816-817.

in that context, these statements shed little light on the proper analysis of a case such as this, where the entire mission of the organization qualifies as charitable, and where the membership form of organization is necessary for the performance of that mission.

3. The briefs of *amici* make clear that *every* non-profit HMO's "primary purpose is to serve [its] paying members," BIO 11 (quoting Pet. App. 14a), and that this structure is essential as a practical matter to performance of its purpose, as well as required by federal law. *See* Prevent Blindness *Amicus* Br. 6; Jones *Amicus* Br. *passim.* As Professor Jones points out, "the court below relied exclusively on the very characteristic defining HMOs as the basis for precluding those organizations from tax exempt status." Jones *Amicus* Br. 8. The Government repeats this error.

4. The Government suggests in a footnote that perhaps some non-profit HMOs could justify their continued tax exemptions based on "an analysis of the facts and circumstances." BIO 11 n.1. But it does not advance a single "fact" or "circumstance" that would distinguish a typical HMO from VSP. Nor could it. If, as the Ninth Circuit held (Pet. App. 3a), healthcare services delivered to HMOs' "paying members" are entitled to *no weight* in determining whether a HMO serves a charitable purpose, or if such services are a positive *detriment* to such a finding as the Government suggests, *see* BIO 11 n.1, then "[t]he opinion below effectively raises a categorical bar against tax exemption for HMOs," Jones *Amicus* Br. 4, as well as for other charitable organizations that do not directly benefit every

member of the community. The Government fails to show how this analysis is wrong. This Court should not permit such a radical departure from existing tax law to stand.

5. The Government's amorphous "facts and circumstances" suggestion provides no more guidance than the Ninth Circuit's opaque "not enough" standard. It leaves taxpayers at the mercy of administrative whim, arbitrary enforcement, and the perils of litigation. If non-profit healthcare providers conclude that they cannot rely on tax exemptions, they will convert to commercial enterprises, changing their charitable orientation to one bent on maximizing profits and shareholder value, with well-established adverse consequences for the quality and affordability of health care. *See* Pet. 24.

6. The Government errs in seeming to argue that VSP is operated primarily for the benefit of its participating providers. BIO 11. Neither court below made such a finding or otherwise relied on such an argument. As the *amicus* brief of Professor Jones points out, "private benefit is an inevitable prerequisite to the accomplishment of a charitable or social welfare purpose. . . . Charitable health care . . . cannot possibly be accomplished without the cooperation of for-profit service providers, such as physicians . . . ." Jones *Amicus* Br. 5. The Government fails to respond.[3]

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[3] The Government recites VSP's ownership of for-profit lens laboratories and a frame manufacturer. BIO 11. Neither lower court mentioned these facts, much less relied on them; the Government does not explain their supposed significance. VSP's for-profit subsidiaries pay taxes on their profits like any

7. VSP and other HMOs are not closed insurance or risk-sharing pools similar to those the Government cites. BIO 14. On the contrary, as the Government points out (and ironically seeks to derive comfort from, BIO 12), VSP actively seeks to enroll new customers.[4] It has been quite successful in extending the national scope and affordability of its vision care – to the point that the Government now seeks to use its very success against it. *See* BIO 4.

8. The Government asserts that there is no direct conflict among the circuits, but there is a manifest conflict "with clearly expressed Congressional intent, recent Supreme Court precedent, state regulatory schemes, and well-established IRS administrative practice." Christopher M. Jedrey & Charles R. Buck, *Vision Service Plan and the HMO Guidelines,* TAXATION OF EXEMPTS 280 (May/June 2006), *quoted in* Pet. 22-23. This conflict is reflected in, among other things, the nearly 40 years of established practice between the IRS's initial recognition of

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other for-profit enterprise. VSP's share of the after-tax profits is used to discharge its charitable mission, holding down what would otherwise be the necessary cost of providing care. Investment in these enterprises does not defeat an exemption to which VSP is otherwise entitled.

[4] Surely no tax significance attaches to the fact that, during the tax year in issue, VSP did not offer individual coverage. Most American healthcare coverage comes in the form of group insurance, either employer-sponsored or through Government programs such as Medicaid and Medicare. VSP actively participates in such programs. If promotion of health care for a substantial segment of the community is beneficial to the community as a whole, as Rev. Rul. 69-545 established and the law of charitable trusts provides, VSP's enrollee base was more than large enough to meet this threshold.

VSP's tax-exempt status and its re-examination of that status in 1999. The Government offers no persuasive justification for the IRS's abrupt reversal in its interpretation and administration of a tax exemption on which non-profits and their tax advisors had relied.

* * *

Whether promotion of health care to a broad but limited class of patients is a "charitable" or "social welfare" purpose under § 501, and whether that conclusion extends to non-profit HMOs that operate in the normal manner of such organizations, are questions directly affecting the financial stability of organizations serving tens of millions of Americans, and indirectly affecting the quality of the health care that they provide. These questions, long thought to be settled, have been upset by the recent positions taken by the IRS and by the decisions below.

II. Congress Has Resolved the Issue of "Unfair Competitive Advantage" in Favor of HMOs Like VSP.

The Government asserts (as the Ninth Circuit did not, *see* Pet. App. 3a) that VSP is also disqualified from a tax exemption because it is "carrying on a business with the general public in a manner similar to organizations which are operated for profit," and a tax exemption would give it an "unfair competitive advantage." BIO 12-13. The Government is wrong, for two principal reasons.

1. The text of neither § 501(c)(3) nor § 501(c)(4) contains any exclusion of charitable or social-welfare organizations that compete with taxable entities.

This asserted limitation is found only in the regulations (and only under § 501(c)(4)). Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii).

All non-profit HMOs (and hospitals and universities and research institutions) operate in competition with profit-making organizations that provide the same or similar services. The Government is plainly wrong in suggesting that the existence of such competition automatically precludes a tax exemption.[5] The Government's resort to such arguments to justify the Ninth Circuit's decision illustrates the precise threat that the decision poses for the tax-exempt community.

2. More important, in Code § 501(m), added by the Tax Reform Act of 1986, Congress resolved the issue of "unfair competitive advantage" as it applies to incidental health insurance provided by a non-profit health maintenance organization such as VSP. At the same time that it ended tax exemptions for non-profits such as Blue Cross that provide "commercial-type insurance," Congress preserved them for non-profit HMOs that offer "incidental health insurance." § 501(m)(3)(B). The Government does not dispute that VSP is a non-profit HMO for purposes of this subsection, or that its services represent "incidental health insurance," and

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[5] Because it is in competition with others, VSP must offer competitive salaries and otherwise operate in an efficient manner to carry out its healthcare mission on a cost-effective basis. This fact does not prevent VSP from being a charitable or social-welfare organization. Again the Government fails to respond to Professor Jones's *amicus* brief, which discusses this issue at pages 5-6.

therefore are excluded from the definition of "commercial-type insurance" in Code § 501(m).[6]

Section 501(m) reflects a Congressional determination that services such as those provided by VSP should *not* disqualify a non-profit HMO from tax exemption, despite potential competition with for-profit entities. Whatever validity the Regulation may have in other contexts, it cannot defeat an exemption in a situation where Congress expressly preserved it.[7]

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[6] The Government appears now to have abandoned its previous position that VSP is disqualified because it "arranges" services rather than "providing" them, an erroneous position that it sold to the district court. Pet. App. 15a. *See* Pet. 9 n.3. Likewise the Government appears to have abandoned its argument, also wrongly accepted by the district court, that cases under § 501(c)(3) are "inapposite" to the proper construction and application of § 501(c)(4). *See* Pet. 14 n.8.

[7] The Government suggests that VSP's failure to invoke § 501(m) in its administrative claim for a refund "raises a question as to this Court's jurisdiction." BIO 14 n.3. As the Government itself observes, however, § 501(m) "does not grant tax-exempt status to any organization." BIO 14. The exemption in this case, if any, must exist under § 501(c)(4). Section 501(m) is simply a statute that must be read together with § 501(c)(4) in order to construe the latter properly – a proposition asserted in the Petition (at 17), and one that the Government does not dispute. The administrative claim was sufficient, and this Court's jurisdiction is not in question. Even in this Court, parties are not confined to the precise arguments made below as long as the ultimate issue was fairly raised. *E.g., PGA Tour, Inc. v. Martin*, 532 U.S. 661, 678 n.27 (2001); *Lebron v. National R.R. Passenger Corp.*, 513 U.S. 374, 379 (1995); *Yee v. City of Escondido*, 503 U.S. 519, 534-535 (1992).

Whether non-profit HMOs are disqualified from tax exemptions if they compete with for-profit entities (as all of them do) is another legal question critically important to a large segment of the economy and to those served by it, which urgently requires this Court's attention in light of the position now taken by the Government.

III. This Court's Prompt Intervention Is Required.

The Ninth Circuit decision should be promptly reviewed by this Court to remove crippling uncertainty in the tax law. This case presents important issues of law that were long thought to be settled, as reflected in Rev. Rul. 69-545, the IRS's acquiescence in the Tax Court decision in *Sound Health Ass'n v. Comm'r,* 71 T.C. 158, 185 (1978), the IRS's recognition of VSP's tax-exempt status in 1960, and its failure to challenge that status for some 40 years thereafter. The Government has never asserted that any relevant or material change has occurred over that time in VSP's organization and activities, and it makes no such suggestion now.

The Government and the IRS are now taking a radically different approach. This bureaucratic fiat, and its success in the courts below, "makes hash" of the law, leaving it in a state of "palpable uncertainty" and "white-hot controversy" that urgently requires this Court's review. *See* Pet. 22.

The new, ill-defined tests, inconsistent with the common law and with the clearly expressed will of Congress, provide no predictive ability whatsoever and no restraint on arbitrary and inconsistent enforcement. Left uncorrected, they will dramatically weaken the non-profit sector of the

healthcare industry, damaging both the quality, the accessibility, and the affordability of all charitable care. *See* Pet. 24.

CONCLUSION

The petition for certiorari should be granted.

Respectfully submitted.

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